

4. Secondary Market

In their selling guides for purchase of mortgages on condominium units, Fannie Mae and Freddie Mac specifically address the requirement of property coverage. These Government-Sponsored Enterprises also recognize flood coverage carried by the association as complying with the mandatory purchase requirements.

a. Fannie Mae

Fannie Mae will accept structure coverage provided under a Dwelling Policy form to supplement inadequate coverage carried by an association if the association carries 80 percent of replacement cost coverage on the condominium. If a condominium association declines to carry any flood coverage, then each unit owner may purchase an individual policy to comply with Fannie Mae's requirements. The Fannie Mae guide also states that unless a higher maximum deductible amount is required by state law, the maximum allowable deductible is the higher of \$1,000 or 1 percent of the face amount of the policy.

b. Freddie Mac

Freddie Mac's guidelines are more restrictive than those required by the statute; it will not purchase loans on condominium units unless the association insures to full replacement value of all improvements. The policy deductible cannot exceed the higher of \$1,000 or 1 percent of the policy's insurance limits.

E. KEY PROVISIONS

The preceding sections of these guidelines discuss specific provisions of the Act and regulations as they apply to an individual borrower or policyholder. This section describes how certain key provisions of the

Act are to be implemented within the lending industry.

1. Tripwires

a. Loan Activity

As stated in the Congressional committee report, Congress views the making, increasing, extending, or renewing of a loan as a "tripwire" for compliance with the flood insurance purchase requirements. This tripwire occurs most frequently upon loan origination, e.g., when a lender knows or has reason to know whether the mandatory purchase requirements apply. Another trigger involves any situation that alerts a lender or servicer to a change in circumstances, e.g., a known map change, or the receipt of a notice to pay the premium to avoid policy expiration.

If a borrower executes a note on improved real estate as collateral for a personal loan, and the lender does not perfect a security interest or mortgage in the structure itself, the loan is not a "designated loan" and, therefore, is not subject to the mandatory purchase requirement.

b. Loan Transfer or Purchase

The transfer or purchase of a loan among regulated lenders or servicers does not constitute the making of a loan, so it does not trigger the mandatory purchase requirement.

It is the lending regulators' position that deeming a loan purchase as a regulatory tripwire could result in the imposition of duplicative and potentially inconsistent requirements on the seller and purchaser of loans sold in the secondary market. As a condition of purchase, a loan purchaser may require the seller to determine whether the property securing the loan is in a Special

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Flood Hazard Area (SFHA). The practice of requiring a seller to make a representation as to compliance with the mandatory purchase requirements also provides additional protection to a loan purchaser. This representation is particularly important when the loans are in communities subject to significant flooding.

However, the Government-Sponsored Enterprises (GSEs) do require flood coverage on any loan transfer to or purchase by them. In the Supplementary Information section of the final regulations, the Federal regulators note that both Fannie Mae and Freddie Mac require their respective sellers and servicers to be in full compliance with the flood insurance statutes. See Fannie Mae Announcement No. 95-10 (June 8, 1995) and Freddie Mac Bulletins No. 94-18 (December 8, 1994) and No. 95-3 (March 13, 1995), included as Appendix 7.

Freddie Mac considers its purchase of a loan as serving as a tripwire, while Fannie Mae's guide requires compliance with the mandatory purchase requirements at the time of loan origination. Consequently, an originator or intermediate holder of a loan will be constrained in passing on a loan that does not meet the criteria of the GSE sales guides. An entity not directly covered by the Reform Act, such as a mortgage banker, will be indirectly required to satisfy the statutory flood insurance requirements if it or any subsequent party attempts to sell mortgage loans to Fannie Mae or Freddie Mac. An unregulated mortgage bank that extends a designated loan without flood insurance will be unable to pass that loan on to the GSE market.

In addition, although a conventional loan may be extended in a nonparticipating community, a lender may find it cannot pass the loan onto Fannie Mae and Freddie Mac. The GSEs have restated they will not buy mortgages secured by properties in

nonparticipating communities if they are located in an SFHA. However, they will accept loans in nonparticipating communities that have not been mapped. The quality control measures instituted by the GSEs set the standard for the industry, even for transactions to private investors who are outside the GSE market.

When any loan is sold and servicing is transferred to the new servicer, notice of the identity of the new servicer must be provided to FEMA's designee.

c. Portfolio Review

A look-back or retroactive loan portfolio review, as well as a review made on a prospective basis, which may disclose uninsured risks, is encouraged but not required by the law. The 1994 Reform Act contains no express or implied language that obligates a regulated lender to review its portfolio of existing loans. Under GSE criteria, a lender or servicer is required to monitor loans sold to the GSE.

The Act encourages lenders and servicers to develop policies and procedures to ensure that, when a determination has been made that property securing a loan is located in an SFHA, coverage is obtained, or, if necessary, force placed. The lender or servicer also must ensure that a policy does not lapse after it has been placed at loan origination.

FEMA/FIA encourages a mortgagee or servicer to require the purchase of flood insurance at any time during the term of the loan when the lender determines that the improved property or mobile home is located in an SFHA. This position is intended to ensure that properties located in SFHAs are covered by flood insurance, regardless of whether the area is designated as an SFHA by the Director of FEMA before or after the loan is originated. For example, when a community or area is remapped by FEMA,

properties that were not located in an SFHA at the time the mortgage was made may later be identified to be in an SFHA.

A lender is notified of remapping through publication in the Federal Register of map change information pertaining to an individual community, or through a compendium that lists all changes during a specific time period. FEMA also offers a subscription service (for a fee) that provides information on map changes every 2 weeks. Some flood zone determination companies provide the service of monitoring map changes that influence the status of loans.

Apart from the requirements mandated on origination of a loan, a regulated lender need only review and take action on any part of its existing portfolio, i.e., “look forward,” for safety and soundness purposes, or if it knows or has reason to know of the need for NFIP coverage. However, scheduled periodic reviews that track the need for flood insurance on loan portfolios are encouraged. The Reform Act does require lenders to check the status of security property for loans when triggered by the statutory tripwires. But the Reform Act did not add remappings to the list of statutory tripwires. Neither the Reform Act nor the agencies’ regulations require lenders to monitor for map changes.

The GSE sales guides have broader requirements than the Reform Act in requiring lenders to continually monitor map changes and changes in community status under the program.

2. Safety and Soundness

Federal lending regulators view adequate flood insurance coverage as an important factor in measuring the safety and soundness of a lending institution that extends loans in at-risk areas. The existence of flood insurance is a component of prudent

underwriting and protects the lender's ongoing interest in its collateral. Each lender must tailor its flood insurance risk management procedures to suit its particular circumstances. The Federal regulators encourage lenders to evaluate and modify their flood insurance programs as needed to comport with both the mandatory purchase requirements and principles of safe and sound banking that may be unique to a particular lender.

A lender's flood insurance needs vary widely depending on lending concentrations within the geographic areas it serves. For example, a high prevalence of loans in an SFHA requires particular vigilance. Institutions that are significantly exposed to the risks for which flood insurance is designed to compensate should determine the adequacy of flood insurance coverage by conducting periodic reviews, or reviews triggered by remapping of areas represented in their loan portfolio. Accordingly, a map change in a community that contains a significant number of loans in an SFHA merits a heightened analysis. The same principle applies to a regulated lender's purchase or transfer of existing loans in a community containing a special flood hazard.

Lending institutions with significant lending in nonparticipating communities should have procedures in place to ensure that loans on properties in flood hazard areas where flood insurance is not available do not constitute an unacceptably large portion of the institution's loan portfolio.

3. Table Funding

The regulations generally follow the RESPA definition in which table funding is defined as a settlement at which a loan is funded by a contemporaneous advance of loan funds and an assignment of the loan to the person advancing the funds. The typical table-funded transaction should be considered a

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loan made, rather than purchased, by the entity that actually supplies the funds, and thus is subject to the mandatory purchase requirements.

Table funding is a mechanism used in the "wholesale" mortgage lending industry for utilizing mortgage brokers in the production of mortgage loans. The brokers who originate the loans are independent contractors not subject to Federal regulatory supervision.

In the typical table funding situation, the party providing the funding reviews and approves the credit standing of the borrower and issues a commitment to the broker or dealer to purchase the loan at the time the loan is originated. Frequently, all loan documentation and other statutorily mandated notices are supplied by the party providing the funding, rather than the broker or dealer. The funding party provides the original funding "at the table" when the broker or dealer and the borrower close the loan. Concurrent with the loan closing, the funding party acquires the loan from the broker or dealer. Wholesale lenders provide the funds for loan closings and acquire the resulting loans, which they sell into the secondary market. Mortgage brokers receive compensation for surrendering the servicing income stream.

Under the regulations, lenders who provide table funding to close loans originated by mortgage brokers or mobile home dealers, such as described above, are deemed to be making, not purchasing, loans for purposes of the flood insurance requirements. Consequently, mortgage brokers are not obligated to comply with the Act in these types of transactions. However, if any mortgage brokers are involved in the processing and underwriting of the application, the lender should contractually delegate to them the responsibility to comply with the various notice, form, and purchase

requirements of the Flood Act, thereby eliminating any duplication of flood determinations and borrower notices.

4. Impact on Servicers

The Reform Act addresses the role of a servicer by sanctioning NFIP-related activity conducted on behalf of regulated lenders.

A servicer, as broadly defined in §4003(a)(11) and §4121(a)(11) of the Act, may be a regulated lender or a private entity assisting a lender as an independent contractor. The provisions of the Act apply to all banking institutions' subsidiaries and service corporations. If a servicer is a subsidiary of a regulated lender, it is included under the purview of the Act. As discussed in Section C of these guidelines, the activities that apply to servicers include escrow, force placement, and zone determination, as well as the submission and receipt of notices. A servicer is directly involved in NFIP activities as a recipient of notices such as a copy of the borrower's Notice of Special Flood Hazard and Availability of Federal Disaster Relief Assistance from the lender and the expiration notice from the insurer.

The regulations that address a servicer's activities treat loan servicers as acting on behalf of regulated lending institutions. Under the regulations, loan servicers are to be held answerable for their actions to the lender by means of contract. A lender thus may fulfill its duties under the Act by imposing its responsibilities on the servicer under a loan service agreement. Accordingly, lenders should include in their loan servicing agreements language ensuring that the servicer will fulfill Federal insurance requirements for escrow, force placement, flood hazard determinations, and the various notices, with conditions for recourse. The Federal regulations state that where deficiencies are found in existing loan servicing contracts, lenders should revise

these agreements to provide for the loan servicer to fulfill Federal flood insurance requirements. It would also be prudent to monitor the activity of servicing agents.

The mandatory purchase provisions do not apply directly to loan originators that are not banking institutions or to servicers that are not acting on behalf of a banking institution. However, these non-bank originators and servicers must see to it that loans they sell or service for a GSE meet the requirements of the Act. Non-bank (e.g., mortgage broker), nonconforming loan lenders who do not originate for GSEs do not come under the authority of the Act.

5. Private Flood Insurance

As part of the notification procedure in making a loan, lenders must inform prospective borrowers of the availability of coverage from private insurers as well as NFIP coverage. However, FIA recognizes the limited availability of flood insurance from the private insurance market.

A lender must consider the suitability of private flood insurance policies only when the mandatory purchase law applies. If NFIP coverage is not available in a particular community, or if the risk is otherwise not eligible for NFIP coverage, e.g., in a nonparticipating community or COBRA area, private flood coverage is an alternative. A lender has more discretion in selecting private flood coverage when NFIP coverage is not available.

When private flood coverage is being considered in lieu of a WYO or direct NFIP policy, a lender is advised to review the FIA's criteria for the private insurer and the form of coverage. Specifically:

- (a) The insurer should be licensed, admitted, or otherwise approved to do business in

the jurisdiction where the property is located, by the insurance regulator of that jurisdiction, except as indicated in (b) below.

- (b) In the case of nonresidential commercial property insurance issued under a policy of difference in conditions, multiple peril, all risk, or other blanket coverage, it should be sufficient if the insurer is recognized, or not disapproved, as a surplus lines insurer by the insurance regulator of the jurisdiction where the property is located.
- (c) The private flood insurance policy should include a requirement for the insurer to give 45 days written notice of cancellation or non-renewal to the insured with respect to the flood insurance coverage. The policy should also state that, to be effective, such notice must be mailed to both the insured and the lender or Federal agency lender, and must include information about the availability of flood insurance coverage under the NFIP.
- (d) The policy should guarantee that the flood insurance coverage, considering deductibles, exclusions, and conditions offered by the insurer, is at least as broad as the coverage under the NFIP policies.
- (e) Lenders should satisfy themselves that a mortgage interest clause similar to that contained in NFIP policies is contained in the policy.

An insurance policy that meets all of the above criteria meets the insurance purchase requirements of §4012a of the Act. To the extent that the policy differs from the NFIP policy, the differences should be carefully examined before the policy is accepted as sufficient protection under the Act.

The FIA notice that contains the criteria for non-NFIP underwritten coverage can be found in Appendix 11.

6. Regulatory Overview

The 1994 Reform Act expressly incorporates new regulatory sanctions into the law and indirectly influences the potential for civil liability. This subsection addresses the regulatory examinations and administrative sanctions, while Subsection E.7 deals with the issue of civil law liability.

a. Regulatory Examinations

As part of the Reform Act, Congress established a task force charged with studying the extent to which the Federal regulatory agencies and the secondary market enforce the Reform Act. The agencies are required to report their findings to Congress. Accordingly, lenders and servicers can continue to expect onsite examination by the regulatory entity primarily responsible for the supervision of the institution as part of their compliance examinations. Similarly, the GSEs will be reviewed by their oversight agency and must conduct a review of their sellers. The examination procedures may include reviewing a sampling of loan files.

The examiners may perform the following activities:

- Review an institution's practices dealing with flood insurance, including a suitable flood zone determination procedure that includes monitoring renewal of coverage and recordkeeping evidencing compliance.
- Ask for proof of the submission of the Notice to Borrower form.

- Observe whether the timing requirements of the various notices have been met.
- Verify that the proper amount of coverage was placed in effect at the time of origination and remains in force throughout the renewal periods, with the lender shown as the mortgagee or loss payee on the policy.
- Check that the lender follows appropriate procedures when an area is reclassified because of a map revision.
- Confirm that a lender or servicer exercises force placement if there is failure to escrow or to continue a policy in effect.

The regulatory examinations will be tailored to the activities of the institution under review. For example, if an institution purchases servicing rights, the examination probably will include a review of the contractual obligations placed on the institution by the owner of the loans. Similarly, if the institution utilizes a third party to service loans, the contract with the third party may be reviewed to ascertain that the flood insurance requirements are identified and the compliance responsibilities are adequately addressed. If the institution transfers servicing of loans to another servicer, it must show it provided notice of the new servicer's identity to the FEMA designee within the prescribed timeframe.

If the institution utilizes a third party to perform flood zone determinations, it can expect a review of its contractual provisions to verify that compliance requirements are identified and covered, including the extent of the third party's guarantee of work.

Relevant parts of the Federal Financial Institutions Examination Council's (FFIEC)

Examination Policies and Procedures can be found in Appendix 12.

b. Regulatory Penalties

Under the 1994 Reform Act, Congress for the first time designated a specific range of regulatory civil penalties that may be imposed administratively when it is found that a "pattern or practice of committing violations" has occurred.

The new law does provide penalties related to covered loans on which a lender fails to:

- Place insurance,
- Escrow flood premium on applicable loans,
- Provide notice requirements pertaining to involved loans, or
- Force place the insurance

in such a way that constitutes a "pattern or practice of committing violations" giving rise to an assessable event, 42 U.S.C. §4012a(f) and (g). Similar provisions exist with respect to GSEs.

The individual penalty amount is \$350 per violation, while the aggregate amount of penalties per year that may be assessed against each institution may reach \$100,000. Penalties assessed will be deposited in the National Flood Mitigation Fund created by the Act in §4104d. Other remedial sanctions consist of unsatisfactory bank ratings, memoranda of understanding, and ultimately, cease and desist orders being issued against lending institutions. In coordination with the FFIEC, the regulatory oversight agencies have amended their uniform rules of practice and procedures to include action taken on the penalty sanctions provisions of the Reform Act.

7. Civil Liability

In legal actions where aggrieved borrowers have instituted actions against lenders for failure to obtain flood coverage, the courts have stated that the mandatory purchase and notice statutes are designed for regulatory purposes to strengthen the NFIP. The court rulings have concluded that the statute and lender regulations are not intended to make "incidental beneficiaries" of aggrieved borrowers who find themselves without NFIP coverage on flood-damaged structures located in a floodplain. In the past, the courts have ruled that the mandatory purchase statute grants no "implied private cause of action" on behalf of borrowers, enabling them to automatically recover based on the failure of a lender to comply with the Act. Courts have agreed with the lenders that the intent of the law is to promote sound land use management and lessen the payments made from the Federal Treasury for disaster assistance, as well as to protect the lenders themselves.

However, several provisions added by the 1994 Reform Act appear to further support the opportunity for an aggrieved uninsured party to pursue a legal action independent of the regulatory mandate. The rather detailed requirements included by the new legislation establish a demanding standard that a lender must meet in order to avoid common law liability. Some lender actions, such as seeking a flood zone determination, attempting force placement, or calling for specific flood information or property reports or appraisals on property subject to the loan, entail the potential of incurring tort liability. Accordingly, a borrower with any substantial claim of lender noncompliance with the Reform Act's mandatory purchase or notice provision may very well have sufficient grounds to prevail in a common

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law negligence or breach of contract action against a lender.

The mandatory notice and compliance requirements of the 1994 Reform Act may significantly increase the number of civil actions by loanholders when there is an allegation of the failure of lenders to comply with the Act's requirements. In view of the potential for civil actions instituted by

borrowers, coupled with the increased regulatory oversight called for under the Act, lenders must now redouble their effort to avoid regulatory sanctions as well as civil liability. Because of the 1994 Reform Act, lenders and servicers need to take additional precautions in all aspects of procuring and maintaining flood insurance in order to protect their own interests and to guard against action by their borrowers.

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